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IN THE
Supreme Court of the United States
OCTOBER TERM, 1956

No. 89

AUTOMOBILE CLUB OF MICHIGAN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR REHEARING

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To the Honorable the Chief Justice of the
United States and the Associate Justices
of the Supreme Court of the United States:

Petitioner, Automobile Club of Michigan, respectfully prays that this Court grant a rehearing of its decision of April 22, 1957, insofar as the decision held that the Commissioner could properly tax prepaid membership dues in the year of receipt rather than when the membership dues were earned.

A rehearing is not requested on the other issues in the case.

GROUNDS FOR REHEARING

I. The majority decision on the issue of prepaid dues is based upon a statement of facts for which there is no support in the record. The facts stated in the majority opinion are simply not the facts of the case.

II. The dissenting opinion of Mr. Justice Harlan, concurred in by Mr. Justice Burton and Mr. Justice Clark, correctly construes section 41 of the Internal Revenue Code of 1939.

The majority decision is in error in holding that section 41 vests the Commissioner with the discretionary right to disapprove a method of accounting which *concededly* more clearly reflects income than the method which the Commissioner would substitute.

Moreover, the Commissioner did not reject petitioner's accounting method on the discretionary ground stated in the majority decision. His position was based solely on an erroneous point of law—that the "claim of right" doctrine compelled a change in petitioner's accounting method.

III. If the majority decision is allowed to stand, the Commissioner's power to reject accounting methods will be virtually beyond the control of the courts, and taxpayers will be harassed on a scale heretofore unknown.

IV. The majority decision unnecessarily invites litigation on issues involving prepaid income.

I.

Before the Tax Court and the 6th Circuit Court of Appeals, the Commissioner contended that the "claim of right" doctrine required the rejection of petition-

er's method of accounting for prepaid dues, and both Courts sustained the Commissioner solely on that ground. Before this Court the Commissioner again urged the "claim of right" doctrine as controlling (Resp. Br. 56-60). Quite properly, this Court refused to hold that the "claim of right" doctrine was applicable to the prepaid dues in petitioner's case.

Instead, the majority decision held that the Commissioner, in the circumstances of petitioner's case, did not abuse his discretion in determining whether the petitioner's method of accounting clearly reflected income.¹ The asserted "circumstances", on which the Court based its conclusion, were stated in the opinion (p. 9) :

"The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member."

In a footnote to the preceding sentence, the opinion stated (p. 9) :

"In this case, substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." (Emphasis supplied.)

¹ This Court stated. (p. 9): "We cannot find, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits". Neither the Tax Court nor the Court of Appeals considered the ground adopted by this Court. Both of the lower Courts relied on the "claim of right" decisions, and neither Court suggested that if the Commissioner was wrong on his "claim of right" argument he would nevertheless have had the right to reject petitioner's method of accounting.

Petitioner respectfully submits that the record utterly fails to support the statement made by the Court in the footnote; that the record clearly establishes that the facts are to the contrary; and that petitioner's method of accounting—rather than being "purely artificial"—related in a most reasonable manner the time when the expenses of earning the dues occurred with the time the dues were returned by petitioner as income.

The undisputed fact is that the greater part of petitioner's expenses in performing its obligations to its members was not incurred "upon a member's demand". The record shows that the expenses incurred "upon a member's demand" were less than one-third of petitioner's expenses in discharging its obligations to the members.²

Using the year 1943 as an example, out of the total expenses in excess of \$1,900,000 (R. 71) only \$548,364.58 (R. 182) was spent for emergency road service. The emergency road service (rendered by independent garages, but paid for by petitioner) is the service rendered "upon a member's demand". A greater amount, more than \$577,000 (R. 71), was spent in the year 1943 simply for salaries and wages of officers and employees—fixed expenses incurred in earning the annual dues. The expense, for example, of keeping a staff of telephone operators constantly on duty to accept calls for road service was necessarily incurred whether or not a particular member had an occasion to call for service.

² Among the obligations incurred upon receipt of dues from a member was the obligation to furnish him for a period of one year, without further charge, 12 issues of the "Motor News", a magazine published monthly by petitioner.

It is obvious that the Court was in error in assuming that the timing of substantially all the expenses incurred in earning the dues income was dependent upon the timing of the member's demand for services. The present record adequately establishes the Court's error. But if there is any doubt on this score the case should be remanded to the trial court for findings of fact on this issue, particularly since this Court attempted, on the basis of facts, to distinguish petitioner's case from *Beacon Publishing Co. v. Commissioner*, 218 F. 2d 697 and *Schuessler v. Commissioner*, 230 F. 2d 722.

The Court's assertion that the allocation of the membership dues was "purely artificial" and bore no relation to the services rendered is unfounded even if it were assumed that substantially all expenses were incurred only upon demand of the members. If petitioner were rendering services for but a single member, it might be artificial to keep books on the assumption that each month petitioner would incur $1/12$ of the expenses in earning the 12 months dues. But any such artificiality completely disappears on giving a moment's thought to the fact that petitioner was rendering services to more than 200,000 members each year.⁸

Petitioner was entitled to keep its books with due regard to the leveling results of the law of averages. Certainly, in the case of 20,000 membership dues paid in December 1943, it was not "purely artificial" for the petitioner to keep its books on the premise that $11/12$ of the emergency calls from those members, be-

⁸ The number of members paying dues to petitioner ranged from a low of 212,865 in 1943 to a high of 261,695 in 1946. (R. 21)

cause of battery failures, flat tires, and the like, would occur in 1944.*

Petitioner's method of accounting was not designed, as the Court's opinion seems to assume, to determine the profit or loss on any particular membership account. The accounting method—adopted when petitioner was exempt from taxation—was designed for, and reasonably serves, the purpose of matching the income from dues earned in one year with the related expenses. Rather than being "purely artificial", as the majority decision erroneously assumed, petitioner's method conforms to generally accepted accounting principles. In the *Handbook of Accounting Methods* (1943 edition, edited by J. K. Lasser), the proper accounting method for dues received by clubs is stated (p. 517):

"Where dues are payable yearly in advance, and monthly income and expense statements are prepared, the proportionate amounts of dues receivable for the month should be taken into income, and the unearned balance should be shown on the balance sheet as deferred income."

In the third edition (1943) of the *Accountant's Handbook*, edited by W. A. Patton, it is stated (p. 114):

"Advances by the customer or the client are perhaps more common in the case of services than in the case of sale of goods * * *. Collections on account of services to be furnished in subsequent periods should, of course, be excluded from current revenue."

* To say that petitioner's method of accounting for dues paid by more than 200,000 members is "purely artificial" is as fallacious as to say that a life insurance company should not be allowed to deduct, with respect to a premium received during the year on a particular policy, a reserve based on average expectancies.

II.

Mr. Justice Harlan in his dissenting opinion, concurred in by Mr. Justice Burton and Mr. Justice Clark, states (p. 3) that he does not understand the majority decision since "the Commissioner does not deny—as, indeed he could not—that the method of accounting used by the taxpayer reflects its net earnings with considerably greater accuracy than the method he proposes". Mr. Justice Harlan's inability to understand is shared by petitioner, and the lower courts might well experience the same difficulty.

The Commissioner rejected petitioner's accounting method solely because he took the position that the "claim of right" doctrine was controlling. He was wrong on that, but under the majority opinion the Commissioner nevertheless had the discretionary right to cast aside petitioner's accounting method and substitute a method which—without dispute—reflected net income less accurately, since the Court (but not the Commissioner) viewed petitioner's method as "purely artificial".

There is no reason to believe that the Commissioner, if he had known at the commencement of these proceedings that his "claim of right" argument was invalid, would nevertheless have refused to accept petitioner's method of accounting. The Commissioner has never contended that petitioner's method was "purely artificial"—his position was that it was immaterial (Resp. Br. p. 60) that the expenses of earning the dues would be incurred in part after the year of the receipt of the dues.

It is submitted, with the greatest of deference, that the majority decision on this issue is erroneous. In

the first place, section 41 does not say—and it is beyond comprehension to believe that Congress intended—that if the Commissioner finds any defect in the taxpayer's method of accounting, then the Commissioner has the uncontrolled right to substitute another method of accounting even though that method concededly reflects income less accurately. In the second place, if any such discretionary power exists in the Commissioner, the Commissioner, and not the Court, ought to exercise the discretion initially.

III.

Judges—as well as taxpayers—have complained that the Commissioner's practice of substituting his accounting method for the taxpayer's method has exceeded all reasonable bounds. Judge Opper, in a dissenting opinion concurred in by five other Judges of the Tax Court, made the following comment in the case of *Pacific Grape Products v. Commissioner*, 17 T.C. 1097, 1110 (reversed by 9th Cir. 219 F. 2d 862):

“The practice of disapproving consistent accounting systems of long standing seems to me to be exceeding all reasonable bounds. * * * Methods of keeping records do not spring in glittering perfection from some unchangeable law but are devised to aid businessmen in maintaining sometimes intricate accounts. * * *

“It will not do to say that respondent should not have disturbed petitioner's accounting method, but that since he has done so, we are powerless to do otherwise. As long as we continue to approve the imposition of theoretical criteria in so purely practical a field, respondent will go on attempting to seize on such recurring fortuitous occasions to increase the revenue, * * *”

The 9th Circuit, in denying the Commissioner the right to reject the taxpayer's method of accounting in that case, referred with approval, in reversing the Tax Court, to the dissenting opinion of Judge Opper. Now it appears that no court will have the right to so repudiate the Commissioner, if the majority decision stands in petitioner's case.

Under the majority decision, the Commissioner has an uncontrolled discretion to reject a taxpayer's accounting method if the taxpayer's method is subject to criticism, and the Commissioner's method must be used even though it reflects income less accurately than the taxpayer's method. The only defense left to the taxpayer is to prove that his method is "glittering perfection" to use Judge Opper's expression. That is an impossible burden for the taxpayer to bear. No method of accounting can meet the test of perfection, and certainly every method of accounting is subject to the charge of some artificiality.

The lack of perfection in an accounting method is never a serious matter if the method used is consistently applied from year to year. But it is a serious matter if lack of perfection gives the Commissioner the right, carte blanche, to reject that method and substitute his own method without any showing that his method is superior to the disapproved method.

This new power given to the Commissioner under the majority decision cannot fail to produce harrassment of taxpayers on a scale not heretofore known. If the decision stands, the Commissioner's power to reject a taxpayer's method of accounting is, for all practical purposes, completely beyond the control of the courts.

IV.

Petitioner assumed, and believes, that this Court granted certiorari on the dues issue because of the conflict of the decision below with the decision of the Court of Appeals for the 10th Circuit in *Beacon Publishing Co. v. Commissioner*, *supra*, and with the decision of the Court of Appeals for the 5th Circuit in *Schuessler v. Commissioner*, *supra*.

This Court did not resolve the conflict because it stated that petitioner's case is distinguishable on its facts from *Beacon* and *Schuessler*. As already pointed out in this petition, this statement of the Court was due to a misunderstanding of the facts in petitioner's case.

In its opinion (p. 9) this Court stated that it expressed no opinion as to the correctness of the decisions in *Beacon* and *Schuessler*. As a result, taxpayers who believe their cases are factually similar to the *Beacon* or *Schuessler* case will continue to resist the attempt of the Commissioner to reject their accounting methods, and no doubt the Commissioner, in the light of this Court's opinion in petitioner's case, will continue to reject their accounting methods. If the taxpayer is in the 5th, 9th, or 10th Circuit, he will be allowed to retain his accounting method if his facts are similar to *Beacon* or *Schuessler*, but a taxpayer with the same facts in the 6th Circuit would lose. The result in other circuits will depend on future litigation, invited by this Court's opinion in petitioner's case.

The failure of this Court to resolve the conflict can be corrected by the granting of this petition for re-hearing.

CONCLUSION

For the reasons hereinabove set forth it is respectfully requested that this petition for rehearing be granted in the interests of justice and good tax administration.

Respectfully submitted,

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Of Counsel:

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LINCOLN ARNOLD.

Dated: May 16, 1957.

Certificate of Counsel

We, Raymond H. Berry and Ellsworth C. Alvord, counsel for the above named petitioner, do hereby certify that the foregoing Petition for Rehearing of this cause is presented in good faith and not for delay.

**RAYMOND H. BERRY
ELLSWORTH C. ALVORD**

Dated: Washington, D. C.
May 16, 1957.